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PATTERNS AND IMPLICATIONS OF JAPANESE STOCKHOLDING

Summary

Japan's increased importance in the global economy has focused attention on a normally unremarkable subject: the pattern of stock ownership in Japan. A broad range of phenomena are different facets of this one subject -- the willingness of corporate management to accept low profits and their freedom to engage in long-range strategic planning; the role of keiretsu or industrial groups in the economy and their impact on market liberalization; barriers to mergers and acquisitions of Japanese companies; shareholders' rights; and the behavior of the Japanese stock market. Trends in patterns of Japanese stock ownership, the reasons behind these developments and their implications will be examined in this report. A review of private and government reactions to current stockholder patterns and a look at factors that may influence them in the future round out the analysis.

Alike . . .

As in other areas, much of the structure of the American stock market was transplanted to Japan during the U.S. occupation after World War II. Companies issue shares that are bought and sold by investors through securities brokers interacting in an institutionalized marketplace. The price of a share on the Tokyo Stock Exchange is determined through a pure, order-driven auction system of matching buy and sell orders. (The Tokyo Stock Exchange is used here as a proxy for all stock trading in Japan since it accounts for about 85 percent of the total volume and value of that country's stock exchange activity. There are small differences in rules and procedures between the TSE and Japan's other stock exchanges as well as with its rapidly growing over-the-counter market, but they are immaterial to the points raised in this report.)

Investors range from individuals to giant financial and nonfinancial institutions, but the system has two important quirks. Unlike banks in the United States, banks in Japan are allowed to hold up to 5 percent of the shares of a nonfinancial corporation. As will be detailed below, banks control a major portion of the total shares outstanding; consequently, their trading activity is a key factor in the market. Again, unlike the U.S. situation, a holding-company structure is illegal under Japan's Antimonopoly Law. This feature, in particular, has left a deep impression on the pattern of Japanese stockholding.

Table 1 presents a historical view of Japanese share ownership by type of investor. It clearly reveals several trends. (Data from the early 1950s must be considered atypical as stock markets were being restarted after the war.) Financial institutions (excluding securities firms) showed the sharpest increase in ownership, with their share of all stock outstanding nearly tripling between 1955 and 1989. Over the same period the nonfinancial corporate sector almost doubled its share of the pie. Together, the two groups expanded their stockholdings from about 30 percent of all shares outstanding in 1955 to nearly 71 percent of the total in 1989. The role of foreign investors underwent sporadic growth spurts, remaining below 2 percent through 1968, reaching a second plateau of 3 percent-plus in the first half of the 1970s, and then fluctuating generally between 4 and 6 percent in the 1980s. These gains clearly came at the expense of individuals; their share fell by more than half after 1955. This shift in the balance of assets between individuals and the business sector is supported by data on a national accounts basis (see Table 2).

It must be underlined that the absolute value of securities owned by all groups has grown tremendously since the 1950s, with much of this growth occurring in the late 1980s; the share held by small investors showed a relative decline only because the business sector added to its portfolio much more rapidly. This shift in share balances is logical in light of Japan's postwar economic history. The rapid growth of Japanese industry and the relatively weak position of consumers versus producers in Japan explain the relative drop in stock ownership by individual investors.

The Japanese case is not unique, however. Stock ownership has shown a similar shift in the United States. According to information from the Federal Reserve Board, institutional stockholdings grew from 16 percent of the total in 1965 to 44 percent in 1989. The share held by individuals fell over the same period from 84 percent to 56 percent. The shift was even more pronounced since the small investor share includes portfolios controlled by trusts and nonprofit organizations, which account for between 25 percent and 30 percent of the total. Flow of funds data indicate that while the share of all U.S. financial assets held by individuals declined moderately between 1970 and 1988 (from 53.6 percent to 43.8 percent), households put considerably less of their total assets into stocks over this period (27.5 percent in 1970 versus 15 percent in 1988). Private estimates of the breakdown of small investors' portfolios reveal a similarly reduced role for stocks -- from as much as 50 percent of total portfolio value in 1970 to less than 30 percent in 1990.

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Table 1: Share Ownership by Type of Investor, All Listed TSE Companies

Year	Public Sector	Financial Companies	Investment Trusts	Securities Companies	Nonfinancial Firms	Individuals	Foreigners
1951	3.1%	12.6%	0.0%	11.9%	11.0%	61.3%	0.0%
1952	1.8	13.0	5.2	9.2	13.8	57.0	0.0
1953	1.0	15.8	6.0	8.4	11.8	55.8	1.2
1954	0.7	16.3	6.7	7.3	13.5	53.9	1.7
1955	0.5	16.7	7.0	7.1	13.0	54.0	1.7
1956	0.4	19.5	4.1	7.9	13.2	53.1	1.8
1957	0.3	21.7	3.9	7.1	15.7	49.9	1.5
1958	0.2	21.4	4.7	5.7	16.3	50.1	1.5
1959	0.3	22.4	6.6	4.4	15.8	49.1	1.5
1960	0.2	21.7	7.6	3.7	17.5	47.8	1.5
1961	0.2	23.1	7.5	3.7	17.8	46.3	1.4
1962	0.2	21.4	8.6	2.8	18.7	46.7	1.7
1963	0.2	21.5	9.2	2.5	17.7	47.1	1.8
1964	0.2	21.4	9.5	2.2	17.9	46.7	2.1
1965	0.2	21.6	7.9	4.4	18.4	45.6	1.9
1966	0.2	23.4	5.6	5.8	18.4	44.8	1.8
1967	0.2	26.1	3.7	5.4	18.6	44.1	1.9
1968	0.3	28.2	2.4	4.4	20.5	42.3	1.9
1969	0.3	30.3	1.7	2.1	21.4	41.9	2.3
1970	0.3	30.7	1.2	1.4	22.0	41.1	3.3
1971	0.3	30.9	1.4	1.2	23.1	39.9	3.2
1972	0.2	32.6	1.3	1.5	23.6	37.2	3.6
1973	0.2	33.8	1.3	1.8	26.6	32.7	3.5
1974	0.2	33.9	1.2	1.5	27.5	32.7	2.9
1975	0.2	33.9	1.5	1.3	27.1	33.4	2.5
1976	0.2	34.5	1.6	1.4	26.3	33.5	2.6
1977	0.2	35.1	1.4	1.4	26.5	32.9	2.6
1978	0.2	35.9	2.0	1.5	26.2	32.0	2.3
1979	0.2	36.6	2.2	1.8	26.3	30.8	2.1
1980	0.2	36.9	1.9	2.0	26.1	30.4	2.5
1981	0.2	37.3	1.5	1.7	26.0	29.2	4.0
1982	0.2	37.3	1.3	1.7	26.3	28.4	4.6
1983	0.2	37.7	1.2	1.8	26.0	28.0	5.1
1984	0.2	38.0	1.0	1.9	25.9	26.8	6.3
1985	0.2	38.5	1.1	1.9	25.9	26.3	6.1
1986**	0.8	42.2	1.3	2.0	24.1	25.2	5.7
1987	0.9	43.5	1.8	2.5	24.5	23.9	4.7
1988	0.8	44.6	2.4	2.5	24.9	23.6	3.6
1989	0.7	45.6	3.1	2.5	24.9	22.4	4.0

*Beginning in 1986 figures based on number of 1,000-share "unit" shareholders.

Source: Ministry of Finance and the National Conference of Stock Exchanges, as cited in Tokyo Stock Exchange 1990 Fact Book.

Table 2: Stock Ownership by Institutional Sector

(share of all stock assets; closing balance; national accounts basis)

Year	Nonfinancial Enterprises	Financial Institutions	Government	Households*
1970	33.7%	26.1%	0.0%	40.1%
1975	33.4	30.7	0.0	35.8
1980	37.7	29.5	0.0	32.8
1981	36.9	31.3	0.0	31.8
1982	34.7	34.2	0.0	31.0
1983	36.4	34.0	0.0	29.5
1984	37.1	34.9	0.0	27.9
1985	36.5	36.0	0.3	27.2
1986	37.6	36.5	0.2	25.6
1987	38.3	35.4	0.1	26.2
1988	37.5	36.5	0.1	25.9

*Includes private, unincorporated nonfinancial enterprises.

Source: Economic Planning Agency, Annual Report on National Accounts, 1990.

In both Japan and the United States, however, the number of people owning stock has grown sharply if erratically. Between 1950 and 1965 the number of share owners in Japan more than tripled from less than 5 million to 17 million-plus. After marking time for a decade, the figure plateaued again between 1975 and 1980 at about 19 million. Following a downturn in the mid-1980s, the number of individual shareholders hit a new high of 21.6 million at the end of 1989. Share owners as a percentage of the total population traced a similar path in both Japan and the United States: rapid growth before 1970 to the mid- to upper teens; a slight decline between 1970 and 1980; and then a spurt to almost 20 percent by the late 1980s.

The role of individual Japanese investors in market activity belies their relatively limited holdings. The number of trades initiated by individuals has ranked first or second since at least 1985 (see Table 3). But the impact of the sharp shift in the balance of share ownership between individuals and corporations also is visible from this perspective. Activity by banks and nonfinancial corporations has risen proportionately, while the share attributable to individuals has fallen by about one-third.

. . . Yet Different

While the structure and the history of Japanese shareholding patterns may be similar to those in the United States, the behavior of Japanese investors, particularly the corporate sector, differs in important respects. Similarly, the Japanese stock market may be structured almost identically to its U.S. counterpart, but it still has a unique character.

Table 3: Stock Transactions by Investment Sectors*

(percentage of the total value of transactions)

	1985	1986	1987	1988	1989
Members	24.2%	26.3%	25.2%	26.5%	23.3%
Individuals	36.9	29.2	26.0	23.7	23.3
Foreigners	12.5	10.9	10.0	7.4	8.7
Insurance Companies	0.9	1.0	1.0	1.1	1.0
Banks	8.1	12.7	16.8	18.9	20.2
Investment Trusts	4.3	4.7	5.1	5.9	7.9
Nonfinancial Firms	8.7	10.9	11.5	12.4	11.4
Others	4.4	4.4	4.3	4.1	4.2

*Figures based on trading on the first and second sections of the Tokyo, Osaka and Nagoya stock exchanges.

Source: Tokyo Stock Exchange Fact Book, 1990.

Keiretsu or Industrial Groups - Both Japanese and American historians cite the dissolution of tightly linked, vertically integrated industrial combines or zaibatsu as a key achievement of the U.S. occupation's program to recast Japan as a liberal democracy. To prevent such tightly knit (and, therefore, easily controlled) behemoths from reappearing, Japan's Antimonopoly Law prohibits the holding-company structure that was the zaibatsu's strength. Despite numerous revisions of the antitrust law, the holding-company ban remains absolute. Nevertheless, major Japanese banks and manufacturers, aware that increased corporate influence often translates into greater commercial strength, quickly organized industrial groups or keiretsu that provided many of the economic advantages of zaibatsu with less formal links. (For a full analysis of keiretsu, see JEI Report No. 2A, January 12, 1990.)

Besides interlocking boards of directors, personnel exchanges and informal group associations, keiretsu members are linked through ownership of each other's shares. For the largest keiretsu the average percentage of a member firm's stock held by other group members has increased over the past 25 years, ranging from 7 to 14.3 percent in 1963 compared to 12.2 to 26.9 percent in fiscal 1988. The ratio can be even higher for some manufacturing keiretsu. Hitachi, Ltd., the core company of the 688-firm Hitachi Group, has an informal policy of holding at least 50 percent of the shares of every group member, according to press reports. Since the number of group-owned shares is kept relatively constant, a significant portion of both outstanding shares and new stock issued by group members is removed from the market.

Cross-Stockholding - A less extreme but more widespread phenomenon is the traditional practice among business partners of holding a small amount of each other's stock as a token of commitment and trust. While the amount involved in each transaction may be tiny, the cumulative total can be consequential since each company does business with many partners. Selling these goodwill tokens occurs only when the business relationship breaks down. A one-sided version of cross-stockholding also exists. The impact on the amount of stock available for trading is similar to that of intragroup holdings.

Stable Shareholders - Institutional investors -- trust funds, pension funds and insurance companies -- have built up huge stock portfolios as a natural consequence of their fiduciary operations. The investment strategy of these giant investors is conservative almost to a fault since they are likely to hold shares of Japanese stocks for years, patiently waiting for capital gains. (Their foreign investment strategy often differs sharply, however, as they try to take advantage of the much higher dividends offered by foreign equities.) Even when institutional investors sell shares to realize capital gains, they often will buy back the stock immediately to maintain the desired portfolio composition.

A second type of stable shareholding is an extreme, often one-sided, version of cross-stockholding. In order to win the business of a customer Japanese companies (usually insurers and banks) will take a significant stake in the firm. Companies in need of capital often will propose this type of arrangement to institutional investors. Similarly, businesses faced with hostile overtures frequently employ this tactic as a defensive measure. Thus, Japanese firms actively seek stable shareholders for two reasons: they form a bulwark against hostile takeovers and they usually, but not always, support the policies of existing management.

Zaiteku or Financial Management - Until the mid-1980s Japanese manufacturers and other nonfinancial companies did not consider active management of their financial resources a priority business undertaking. The appreciation of the yen against most major foreign currencies (which hurt the profitability of exporters and related firms) and the country's skyrocketing stock and real estate markets worked like stick and carrot, respectively, to change this attitude. For many companies quick and sizable profits from stock and land speculation masked losses from basic operations. This attitudinal shift is a major factor behind the upsurge in corporate stock trading in the past several years.

Big Four Securities Firms - Unlike in the United States, four Japanese brokerage houses -- Nomura Securities Co., Ltd., Daiwa Securities Co., Ltd., Yamaichi Securities Co., Ltd. and Nikko Securities Co., Ltd. -- control a dominant share of trading on Japan's stock and bond markets. Until 1989 they directly accounted for about 40 percent of all Tokyo Stock Exchange volume, a figure that rises to 60 percent or more if trading by smaller affiliates is counted.

Such a concentration of market power can distort trading patterns. Buy and sell recommendations, for example, often were based on which stocks the Big Four were promoting at any instant rather than the economic fundamentals of the favored companies. TSE trading was characterized by "themes" -- furious activity focusing on groups of companies selected by the Big Four for some (not always realistic) reason -- that lasted no more than a few days and often as little as a few hours. While 1988 Ministry of Finance guidelines limiting brokerage activity (see below) have reduced the influence of the Big Four in the spot market for stocks, observers complain that the oligopoly has evaded this guidance at the margins by dominating activity in new markets, such as stock and bond futures. This dominance corrupts the invisible hand of supply and demand in Japanese equity markets and puts investors on unequal footings.

Why It Matters

The effects of this pattern of stockholding are surprisingly profound. Certain consequences long have been the target of foreign criticism, especially

by the United States. Other results, however, recently have become subjects of domestic debate.

• Stock Trading Effects - The basic feature from which all else derives is the severely limited amount of stock available for active trading due to cross- and stable shareholding. According to Japanese and foreign estimates, cross- and stable stockholdings account for between 60 and 70 percent of the outstanding shares on the TSE. (New equity flotations do not change the situation since cross- and stable shareholders are expected to maintain their previous ownership ratios.)

While on paper the TSE's 300 billion-plus shares outstanding appear to make it a highly liquid market, its true liquidity is far less because of cross- and stable stockholding. Combined with the market influence of the Big Four securities firms, the TSE not surprisingly has developed a reputation for being a manipulated market. The Big Four and large investors can sway the price of a particular stock or even the entire market. Such influence is not unlimited (the TSE's drastic decline in 1990 makes this clear), but it cannot be ignored.

Small investors particularly are hurt by these and other market distortions. Inside information in Japan includes not only the sort of key corporate data that fall under the U.S. definition but also the tips and the rumors on which shares become a target of interest by the Big Four and other traders. Since individual or small investors rarely are privy to such information, they do not benefit along with in-the-know investors from the market's swings. The TSE's reputation for manipulation, coupled with recent scandals involving brokers compensating major clients for trading losses (see JEI Report No. 40B, October 19, 1990), has caused small investors to question the wisdom of putting their money into equities.

Cross- and stable stockholding also can amplify market swings. When the market is rising, for example, companies issue new shares. Stable shareholders are obligated to buy a major portion of these shares; that boosts the market and completes the virtuous circle. According to Japanese stock analysts, a significant percentage of the funds raised during the TSE bull run flowed back into the market because of cross-shareholding policies. Japan's ownership pattern becomes a vicious circle when the market is dropping, as was demonstrated in 1990. Falling stock prices shrank the value of corporate investment portfolios, worsening business results and depressing prices further. Since the web of cross-stockholding is so extensive, significant price movements in enough stocks can pull the entire market in the same direction.

The shrinking share of stocks owned by individuals is a growing concern to stock market watchers. Because institutional and corporate investors can issue trading orders involving their entire portfolios in seconds thanks to computerized trading and these orders usually involve millions of shares, stock market administrators worry that the market will become excessively volatile as the role of big investors grows. Small investors tend to ride out market vagaries, and they often are the most active bargain hunters when the market is down. Both tendencies help to stabilize swings in share prices. As mentioned above, individual investors still account for a major portion of trading activity, but their role is declining relative to trading by financial firms and other members of the business community.

• Independence of Corporate Management - Analyses of the competitive strengths of Japanese corporations often cite management's willingness to accept low profits for many years, industry's long-range outlook and steady, persistent corporate effort as critical components of their commercial success. While other factors are involved, a major reason management can adopt policies like these is the support top executives derive from cross- and stable shareholders. As long as management can count on the support of two-thirds of the stockholders, any effort to influence company policies can be defeated, whether it comes from a stockholder or an outsider. Management also can force through such unpopular policies as low dividend payouts and low per-share dividends with the backing of cross- and stable shareholders.

While American and European companies devote half or more of their profits to dividends, the average for Japanese firms listed on the TSE was only 27.6 percent in 1989. Most publicly traded firms set their dividends based on a share par value of Y50 ($0.37 at Y135=$1.00); nearly 60 percent of the TSE-listed companies have dividends of just Y5 to Y7 ($0.04 to $0.05) per share. Furthermore, dividend rates rarely are altered, even when a firm enjoys excellent profits. Combined with relatively high share prices, TSE stocks have astronomical price/earnings ratios (60 at the market's 1989 peak and still in the high 40s compared with an average in the 20s for shares listed on the New York Stock Exchange) and miniscule yields (an average of less than 0.5 percent versus more than 3 percent in the United States).

Even when a company is experiencing difficulties, cross- and stable shareholders are more likely to offer assistance to current management than call for its ouster. Dissatisfaction must reach extremes before cross- and stable shareholders balk.

• Shareholders' Rights - The converse of management independence is limited shareholders' rights. In Japan's hierarchical society management's position is superior to that of stock owners; the former have the power to make all decisions and the latter are relegated to accepting these decisions and remaining silent. An indication of the passive role share owners are expected to take is that the majority of Japanese firms not only hold their annual stockholders' meetings on the same day and at practically the same time but they informally compete to see which firm has the shortest meeting. (More than 1,600 publicly listed firms held their annual meetings on the same day last year, with the average gathering lasting less than 30 minutes.)

Japan's commercial code clearly defines the rights of shareholders with regard to management. If a shareholder owns the following amount of a company's outstanding stock for at least six months, he or she can:

-- 1 percent - Make proposals at the shareholders' meeting; vote in that meeting; and inspect the register of shareholders.
-- 3 percent - Convene a shareholders' meeting.
-- 10 percent - Inspect and make copies of accounts and other company records.
-- 33.4 percent - Veto decisions that require a two-thirds majority.
-- 50 percent - Appoint director(s).
-- 66.7 percent - Remove director(s); change the articles of incorporation; and approve mergers and the transfer of substantial assets.

Backed by cross- and stable shareholders management often can brush aside any proposals made by small investors as well as their objections. In addition, Japanese organized crime has extended a tentacle into the picture. Sokaiya or "professional shareholders" buy a 1 percent stake in a company either to: harass and disrupt the annual meeting (they then extort money from management in exchange for a promise not to do it again); or verbally and/or physically suppress shareholders that may be troublesome to management (also extorting money from management for this service). Last year, for example, sokaiya disrupted more than a dozen annual meetings, while others gave the bum's rush to shareholders who tried to question management policies, such as antinuclear protesters and T. Boone Pickens, the American corporate raider. Although Mr. Pickens is not a popular figure in Japan, his cause has attracted attention and spurred debate.

Via his Texas investment bank, Boone Co., Mr. Pickens bought 20.2 percent of a publicly traded Japanese automotive parts maker, Koito Manufacturing Co., Ltd., in April 1989. The purchase made Mr. Pickens Koito's largest single shareholder, followed by Toyota Motor Corp. with its 19 percent stake. Disregarding Mr. Pickens' professed desire to expand Koito's sales and his requests for representation on the company's board of directors, management has held Mr. Pickens at arm's length with the backing of the firm's friendly shareholders led by Toyota. Although Mr. Pickens has increased his Koito stake to 26.4 percent, his position has been damaged by revelations that he purchased the stock from a Japanese investor with a reputation for greenmail. Koito's management consistently has charged that Mr. Pickens is interested only in greenmail or is acting as a front for the Japanese greenmailer.

Mr. Pickens' situation has attracted Japanese and American attention -- if for slightly different reasons. In the United States, where the ownership of even big blocks of a publicly traded company's stock easily can change hands and where stock owners have a voice in corporate affairs, the issue is one of fairness and freedom of investment. Koito's treatment of its largest stockholder would be highly unusual in the U.S. context. It smacks of xenophobia and discrimination to Congress and could worsen bilateral ties. In Japan Mr. Pickens' actions are held up as a perfect example of a negative aspect of financial liberalization and internationalization. Mr. Pickens does have his Japanese defenders, however, and even Koito's management acknowledges that Japanese shareholders should be treated with more respect.

There have been other important developments in the area of shareholders' rights that involve only Japanese parties. In a surprise 1989 decision a Japanese court ruled illegal a common antitakeover defense tactic -- the exchange of new shares between target companies at a below-market price in order to dilute the stake of a hostile suitor. As the encounters between sokaiya and antinuclear protesters illustrate, stockholder activism (whatever the cause) is increasing gradually. Perhaps the most important development, however, is the revolution in expectations about rates of return on investments sparked by the reform and the liberalization of Japanese financial markets. Not only are individual shareholders griping about the measly dividends offered by publicly traded Japanese companies but institutional investors and the government have added their voices to calls for change (see below), auguring an improvement for Japanese investors in the future.

• Mergers and Acquisitions - The natural extension of the shareholders' rights debate is the discussion over mergers and acquisitions in Japan.

For political as well as economic reasons this debate is of particular interest to the United States. As suggested above, the U.S. market is open to mergers and acquisitions by domestic and foreign investors alike. The pattern of cross- and stable shareholding in Japan, however, reduces the chances to almost nil that an unwelcome bid for a publicly traded Japanese company will succeed. This subject has been broached in bilateral talks and discussed on Capitol Hill.

The Japanese government correctly argues that there are no legal barriers to hostile takeovers in Japan (in fact, as described below, Tokyo has acted to ease rules for public tender offers); the barriers are cultural and not subject to government control. Many Americans and an increasing number of Japanese point out, however, that cross-stockholding is a response to the Anti-monopoly Law's ban on holding companies. If this ban were lifted, they argue, Japanese firms would restructure and could become more receptive to mergers and acquisitions. Ironically, the chances that the law will be amended are high currently but for totally unrelated reasons.

• Market Access Issues - Frustrated that the dismantling of Japan's formal trade barriers has not led to more of a spurt in exports, U.S. trade negotiators have focused on the clubby nature of keiretsu and other cross-stockholding groups as a major impediment to trade. Keiretsu and antitrust policy were mentioned specifically in the June 1990 final report on the Structural Impediments Initiative. ". . . [T]here is a view that certain aspects of keiretsu relationships also promote preferential group trade, negatively affect foreign direct investment in Japan, and may give rise to anticompetitive business practices," the Japanese government said in the report. It pledged that antitrust policy would be toughened and foreign direct investment promoted. Because fundamental legal and behavioral changes are involved and since Washington has warned it will monitor Tokyo's actions on this issue, keiretsu and cross-stock ownership will be on the bilateral agenda for some time.

Reactions and Responses

Government and private financial analysts have been aware for some time of the multiple consequences of the current pattern of stockholding in Japan, yet only recently have changing international and domestic economic and political environments led to a reconsideration of benefits and costs. As Japan's role in the global economy increases, it is coming under pressure to bring its economic structures, rules and practices more in line with international norms. In order to maintain Japanese access to overseas markets, keep the country's competitive edge, make Japanese markets centers of international activity and spread the nation's wealth more evenly, public and private steps have been taken that may affect the pattern of share ownership in Japan.

• Securities Trading Reforms - In an effort to improve the transparency of trading in Japan, the Ministry of Finance has taken aim at two areas: reducing the role of nonmarket influences and toughening trading regulations. In 1988 MOF issued informal guidelines to limit the influence of any single brokerage house on share prices; brokers were asked to limit their trading of a stock to no more than 30 percent of that issue's monthly trading volume. The MOF guidance has been surprisingly effective; the Big Four's trading volume as a share of total market turnover fell below 40 percent in 1989. The rule worked perhaps too well in early 1990, however, as it hamstrung the Big Four's efforts to support the falling market. MOF has relented on the 30 percent cap for the time being, but it can reimpose the ceiling at any time.

Starting in 1989, tougher insider trading rules have played a major role in MOF's drive to improve the operation of Japan's market. Comprehensive and specific rules as to what constitutes insider trading and harsher penalties at least have drawn a sharp line between legal and illegal activities. Securities firms have responded with their own internal rules, but a number of observers still feel that many gray areas exist. Several investigations and indictments under the new rules have shaken traders and restored some investor confidence.

The governing board of the Tokyo Stock Exchange has buttressed the government's actions on insider trading with complementary changes in rules and regulations. More to the point, the TSE has proposed measures to induce individual investors to move back into stocks, including reducing the minimum size of a trading lot. The current minimum lot is 1,000 shares. (Unlike its New York counterpart, the TSE does not offer odd-lot trading, wherein brokers accumulate orders of less than 100 shares, package them into orders of at least the minimum size and conduct the transaction, thereby permitting investors to buy as little as one share.) Many individuals cannot afford to buy such a large block of stock, especially of desirable, but expensive, blue-chip issues. Since Sony Corp. and Fanuc Ltd. cut their trading minimum to 100 shares, Japanese analysts report that about 65 percent of the turnover in these issues occurs in that size lot. Japanese firms reportedly fear, however, that reducing the minimum lot size will make it easier for sokaiya and others interested in meddling with management policies to gain entry to annual meetings.

With the TSE down sharply from the historic high achieved at yearend 1989 and little optimism that a new bull market will arrive in the near future, the capital gains potential of stock is limited. As a result, the TSE's governing board and the government are urging publicly traded companies to increase their dividends to improve the attractiveness of stocks as an investment. So far both the TSE and the Ministry of Finance have avoided mentioning any specific numbers. Both organizations plan to meet this year with business leaders to discuss the topic. It has been rumored, however, that MOF has told brokers and banks that it will not look favorably on new stock issues that carry low dividends. Again, though, MOF has not specified what constitutes a "low" payout rate.

- Securities Purchase Reforms - In direct response to the Recruit Cosmos Co., Ltd. stock scandal of 1989, government and private regulators have set detailed rules for prepublic-offer private sales of stock, intended to prevent windfall profits. MOF also is debating altering the rules for public offerings that would substitute an open bidding system for the current arrangement of selective placement. Regulators also are modifying the methods of setting prices for newly listed shares, increasing the use of market mechanisms and linking prices more directly to the business fundamentals of issuing firms. Traditionally, a company issuing new shares sets the initial price at a level comparable to that used by other firms of similar financial background in its field, regardless of its business position and prospects. MOF is discussing rules that would set the price according to the issuing company's net assets, net profits and dividend rate.

- Mergers and Acquisitions - MOF has implemented several initiatives in this field. Although public tender offers for a company's stock, a common occurrence in the United States, have been allowed in Japan since 1971, only three such offers ever have been made. (One involved an attempted takeover of

a Japanese automotive parts maker by an American firm; the other two were offers by parent companies seeking to take a public subsidiary private.) To improve the chances of success, notification of a tender offer now can be made right before it is announced (versus the prior 10-day notification period). Moreover, the tender offer can last up to 60 days versus the former 30-day limit. (A 20-day minimum still is in effect.) The terms of the offer also can be changed after it has been started (but not after it ends), and it can be withdrawn before its announced closing date. Tendering stockholders also gain better treatment since they can rescind their tender at any time during an offer's life.

To prevent collusive transactions, purchases of 5 percent or more of a publicly traded company's stock must be conducted as a public tender offer except in five special cases. (The most important exception is that this rule does not apply to over-the-counter sales made through a securities firm.) Although this regulation may increase the cost of friendly takeovers because they have to be conducted publicly and on the open market, it also could make unsolicited offers more common since hostile bidders can offer better terms.

Another major change -- the one that forced Mr. Pickens to reveal the source of his Koito stock -- is the so-called 5 percent rule. To discourage stock cornering and other speculative ploys, owners of more than 5 percent of a publicly traded company's shares as of December 1, 1990 have to disclose detailed information to MOF, the company involved and relevant stock exchange officials. These details include shareholders' names, the number and the types of shares held, the shareholders' investment objectives, sources of funds used to purchase the shares and a 60-day trading history. The rule applies to affiliates and other persons closely related to shareholders.

Initial reports from brokers on the 5 percent rule's impact have been positive. According to MOF, 4,474 investors filed disclosures by the December 7, 1990 reporting deadline. While most simply have confirmed well-known relationships, others have proved enlightening, such as Mr. Pickens' dealings with a known speculator. Brokers are confident that greenmail and other speculative ploys will be much less common thanks to the new rule, reducing artificial manipulation of share prices. Both MOF and private observers hope that the disclosure requirements will restore investor confidence in the stock market.

Future Factors

Clearly many steps already have been taken that will affect the pattern of stockholding in Japan. Several issues, however, could have broad influence on future trends:

- Political Fund-Raising - As revealed in the Recruit Cosmos scandal, making contributions to politicians through gifts or sales of stock at below-market prices occurs in Japan. Japanese observers predict that all the new rules and regulations regarding private stock placements and insider trading will not prevent this kind of activity. Although such transactions constitute only a small percentage of total trading, they add significantly to small investors' distrust of the stock market. Prime Minister Toshiki Kaifu has made reform of campaign financing a major goal of his cabinet, but it is unlikely that fundamental changes will be initiated.

• Keiretsu - Japanese debate on this issue is deeply divided between those who stress the "economic rationality" of such an industrial structure and those concerned with improving consumer benefits or smoothing foreign relations. Many Japanese attribute at least some of the nation's rapid economic reconstruction and current international competitiveness to the keiretsu system. Closer to the heart, corporate groupings echo the group-oriented nature of Japanese society. If Japan expects to harmonize its economy with the global economy, the nation must address the issue of exclusive economic groups.

• Government Attitudes Toward Producers and Consumers - To accelerate postwar economic reconstruction, Tokyo's fiscal and monetary policies were canted toward producers to the detriment of consumers. Only in the past few years have concerns about the quality of life in Japan and the sources of the country's economic growth forced Tokyo to reconsider policies that served the nation so well. Stronger protection for small investors and beefed-up shareholders' rights are two possible expressions of a more balanced approach to the demands of consumers and producers.

• Financial Liberalization and Regulation - Already having had a major impact on stockholder and stock issuer behavior, Tokyo's drive to reform and restructure Japan's financial markets still has the greatest potential to alter the current pattern of share ownership. For example, to address the remaining barriers between commercial and investment banking, MOF is considering dropping the Antimonopoly Law's ban on holding companies; that move would affect many shareholding-related issues. Even now tougher financial competition among lenders as well as borrowers is putting strain on traditional business practices, such as keiretsu and cross- and stable shareholding. With the bottom line becoming more important as competition heightens, maintaining friendly business ties is starting to lose its priority. The growing presence of foreign firms also could shake up the Japanese market as they introduce new ideas and practices, such as foreign brokers' active use of computer-driven index arbitrage trading strategies.

Of less certain impact is the government's campaign to crack down on insider trading and other forms of market manipulation. Even before the ink was dry, some Japanese analysts labeled the new insider trading rules ineffective and impotent. Revealingly perhaps, local prosecutors, rather than the Ministry of Finance, have initiated investigations under the new rules.

Two areas should be of particular interest in the future. The nascent movement for greater shareholders' rights could be the first sign that the pro-producer attitudes of the government and of the common citizen may be changing. Such a shift, if it becomes widespread, will have implications far beyond stockholding patterns. The other point of interest will be the behavior of big and small investors if a bear market continues for an extended period of time. Predicting investor behavior in a boom market is not a difficult task given the strong group mentality of the average Japanese. A falling market, in contrast, is a true test of investor mettle and of assertions that small investors reduce market volatility.

For further information, contact Jon Choy.

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The views expressed in this report are those of the author and do not necessarily represent those of the Japan Economic Institute.

MICROCOPY RESOLUTION TEST CHART
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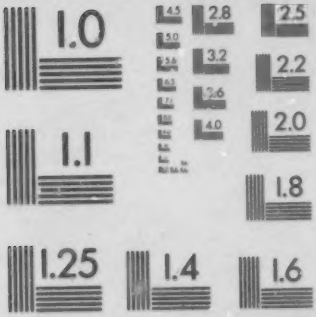

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